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C O N F I D E N T I A L SECTION 01 OF 03 CAIRO 000035

SIPDIS

STATE FOR NEA/ELA, NEA/RA, AND EB/IDF
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COMMERCE FOR 4520/ITA/ANESA/TALAAT

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TAGS: ECON EFIN ETRD EINV PREL EG
SUBJECT: THE EGYPTIAN ECONOMY IN 2006 - CAN EGYPT SUSTAIN

REFORM?

REF: 05 CAIRO 9314

Classified by ECPO Acting Counselor John Desrocher, for reasons 1.4 (b) and (d).

SUMMARY AND INTRODUCTION

¶1. (C) As noted in reftel, the Mubarak regime has clearly recognized the need for wholesale economic reform to avert a serious deterioration in employment prospects and living standards for Egypt's burgeoning population and to keep Egypt afloat in the global economy. Gamal Mubarak's Policy Secretariat in the National Democratic Party (NDP) began an

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economic policy review in 2002, but real change only came in 2004, with the appointment of reform-oriented economic ministers. These ministers took some bold steps upon appointment, including slashing tariffs and eliminating diesel subsidies. The reformers took further steps in 2005, including cutting tax rates and accelerating privatization of state-owned enterprises. Reaction in the local business community has been positive, but business leaders have called for deeper economic restructuring and some have questioned the NDP's long term commitment to reform. Others have speculated that the real aim of economic reform is to alleviate domestic and international pressure for political change. As Egypt heads into 2006, economic reform itself may become more politicized, as those who stand to lose from changes in the status quo begin to more actively resist continued reform efforts. End summary and introduction.

ADDRESSING STAGNATION AND UNEMPLOYMENT...

¶2. (SBU) After years of economic stagnation that culminated in a currency devaluation in early 2003, the Mubarak regime has clearly recognized that it cannot maintain the status quo in the economic realm. Although official unemployment is 10%, private analysts put the actual figure as high as 20%. Underemployment is also a significant problem, as many of the approximately 600,000 workers who join Egypt's labor force each year are college graduates with limited job opportunities in the current economic environment.

THROUGH TARIFF AND TAX CUTS...

¶3. (U) The Nazif administration followed its first big reform, the reduction of customs tariffs in September 2004, with a similar reduction in tax rates in June 2005. A new tax law reduced personal and corporate tax rates by half, and changed the relationship between taxpayers and the Tax Authority. Taxpayers now file self-assessments, which the Tax Authority accepts as accurate, with an option to audit. Under the previous system, the Tax Authority assessed taxes for individuals and corporations and presented taxpayers with a bill. This process could take years, leaving business owners, as well as potential lenders and investors, in the dark regarding what a firm's tax bill would be and when it might come due.

¶4. (U) The aim of the new law, according to Minister of Finance Youssef Boutros Ghali (YBG), was not only to stimulate economic activity, but to encourage the large informal sector to register with the government and begin paying taxes. YBG asserted that growth resulting from the reduction in tax rates, combined with incorporation of informal activity into the tax base would offset decreases in revenue from the tax cuts. This logic largely proved valid with regard to the tariff reductions of 2004. In 2004 YBG predicted a 37% drop in revenue due to the tariff cuts, but actual figures for fiscal year 2004/05 showed a decrease of only 16%. The difference was made up by an increase in the

volume of imports stimulated by lower tariffs.

AND PRIVATIZATION

¶5. (U) As 2005 draws to a close, economic growth has reached an annualized rate of 5.3%. Most of the growth is from FDI, which increased from $400 million in FY 03/04 to $3.9 billion in FY 04/05. While most of this investment is in the petroleum sector, non-petroleum investment still trebled. Foreign investors are drawn by a booming stock market and Minister of Investment Mahmoud Mohieldin's aggressive sale of some of the GOE's most valuable state-owned enterprises. In 2005, the Ministry of Investment (MOI) divested GOE shares in several joint venture banks, sold a controlling stake in Egypt's largest cement producer to a French company, and held IPOs for two major petroleum firms and 20% of Telecom Egypt (TE), the country's fixed-line telephone monopoly. In the case of TE, the IPO was oversubscribed 10 times by individual investors and 60 times by institutional investors. Proceeds from the sale of public assets have already generated $920 million in revenue for the GOE in the first half of the current fiscal year.

GROWTH FOCUSED MOSTLY IN EXPORT SECTORS

¶6. (U) Much of the investment and economic growth seen in 2005 was concentrated in export sectors, particularly the petroleum field as noted above. The GOE encouraged development of its natural gas industry, and is expected to shift more resources into natural gas exploration as Egypt's oil reserves dwindle. Textile exports also increased, particularly to the U.S. from the Qualifying Industrial Zones. As exports increased, however, so did pressure on the Egyptian Pound (LE). The Central Bank of Egypt (CBE) has maintained the currency stable at near LE 5.75/$ for most of 2005 by building Egypt's foreign currency reserveS, which have now reached $21 billion. Conditions may be right in 2006 for an appreciation of the LE, as domestic demand increases due to lower inflation and interest rates. YBG signaled as much in early September, when he said publicly that the GOE would let the LE appreciate once CBE's foreign reserves reached $23 billion.

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OUTLOOK FOR 2006: REFORM CAMP IN CABINET GROWS...
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¶7. (SBU) President Mubarak signaled his commitment to continued economic reform when he announced the new cabinet line-up on December 27. All of the reform-oriented ministers will remain in their current positions, and the reform camp will actually expand. Mohammed Mansour, a highly regarded businessman with close ties to the U.S., has been named Minister of Transportation. Mansour is the cousin of another cabinet reformer, new Housing Minister and former Tourism Minister Ahmed Maghrabi. Mansour also thinks and operates much like a third cabinet minister drawn from the private sector, his friend and fellow Alexandrian, Trade Minister Rachid. The new ministers of agriculture, health, and tourism also bring extensive private sector experience to government.

...BUT CAN THEY MEET THE CHALLENGES?

¶8. (SBU) The new cabinet will face major challenges in implementing continued economic reform. While the business community and wealthy elites have been generally favorable to the Nazif administration's reform agenda, the average Egyptian (too poor to pay income tax or, even after tariff cuts, buy imported goods) perceives no direct benefit from the reforms to date. Continued reform will, of necessity, have to address the massive subsidization of food, water and energy, the biggest drag on the GOE's budget. The deficit reached 10% this year and will continue to increase absent steps to reduce subsidies and rationalize the bloated public sector.

¶9. (C) Surveys indicate that most Egyptians still favor the security of public sector jobs over private sector employment, but the Nazif administration has already indicated that it will not create unnecessary public sector jobs to control unemployment. The business community asserts that for the private sector to create more jobs, a reduction is needed in bureaucratic impediments to economic initiative. While the GOE has taken some steps in this regard, such as accelerating the pace of privatization of state-owned enterprises and creation of the MOI's "one-stop shop" for business development, entrepreneurs still face numerous hurdles in dealing with the government offices. Anecdotal evidence from private sector contacts indicates that the

one-stop shop has merely concentrated all the hurdles in one location, but has not made them easier to overcome. Private sector leaders have made it clear that they see a free trade agreement with the U.S. as essential to prompting the structural economic reform needed to allow the private sector to take the lead in Egypt's economy.

¶10. (C) Corruption also remains a significant impediment to growth, and may become more difficult to control as economic reform progresses. As the GOE continues its efforts to strengthen the institutions necessary for efficient functioning of the economy, those efforts will likely bump up against entrenched bureaucratic interests, and perhaps the interests of high-level members of the NDP and Mubarak regime. Minister of Investment Mohieldin, addressing the AmCham and visiting representatives of Deutsche Bank, noted that for true economic development to occur, businesses would need to be free to establish ventures without "gaining approval," a subtle recognition of the widely held belief that all economic activity must be "approved" by the highest levels of the Mubarak regime. Minister of Trade Rachid was even more outspoken at another AmCham conference, at which he stated that corruption was harming economic growth and should not be tolerated. Unless corruption is addressed, economic reform may indeed begin to threaten more than just the bureaucracy, and may therefore go the way of Egypt's political reform agenda, i.e., halting steps as opposed to the sweeping reforms seen in 2005.

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